

**Testimony of  
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to the  
Committee on the Budget  
United States Senate  
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Chairman Conrad, Ranking Member Sessions, members of the Committee, I'd like to thank you for the opportunity to share my views on the economy and the budget with you today.

Even in this fractious climate, I think everyone agrees that the recovery from the Great Recession has been far too weak. New GDP numbers are out tomorrow, but the ones in hand today show a compound annual growth rate of real GDP of only 2.4% since the recovery began. That's a rate we should be satisfied with starting from full employment, not from the massive unemployment of mid-2009. And growth over the last three quarters has averaged only about half that pace.

Some observers view this weak macroeconomic performance as unsurprising, maybe even inevitable, given the devastating financial crisis that brought on the recession. In a justly-famous book, Carmen Reinhart and Ken Rogoff emphasized that it takes a long time for economies to recover from banking and financial crises.<sup>1</sup> But what is often not noticed is that the main reason behind this discouraging fact is the extraordinary depth of the recessions that financial crises cause, *not* the slow recoveries thereafter, as three Federal Reserve researchers

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<sup>1</sup> Carmen Reinhart and Kenneth Rogoff, *This Time Is Different*, Princeton University Press, 2009.

have recently pointed out in an important paper.<sup>2</sup> It takes a long time to climb out because the hole is so deep, not because the ascent is so slow.

That should be a lesson to us all. We are not condemned to a sluggish recovery, much less to one that never gets the unemployment rate back below 6% or 7%, as some have claimed. Many factors are relevant to the speed of an economic recovery, including both national economic policy and luck. Let me start with the first and finish with the second.

The U.S. policy response to the devastating recession was vigorous, but is petering out. The Federal Reserve promulgated a veritable laundry list of, first, emergency responses to the crisis and, then, measures to support the recovery. The Fed deserves kudos for all this, and it is probably not finished. But it is down to very weak weapons, and I want to focus here on congressional actions instead.

I realize that, for many members, voting for TARP was about as much fun as root canal work. After all, how many voters have ever thanked their elected representatives for bailing out banks? But I have little doubt that history will record that the votes for TARP in October 2008 and the Recovery Act in February 2009, followed by the highly-successful bank stress tests that spring (which required the availability of TARP funds), turned the tide--making a horrific situation merely terrible.

In a 2010 paper, Mark Zandi and I used a large-scale model of the U.S. economy to estimate the overall impact of all the policy responses, taken together, on the economy.<sup>3</sup> It is still, to my knowledge, the only such estimate. We estimated that the policy responses made

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<sup>2</sup> Greg Howard, Robert Martin, and Beth Anne Wilson, "Are Recoveries from Banking and Financial Crises Really So Different?," International Finance Discussion Papers No. 2011-1037, November 2011.

<sup>3</sup> Alan S. Blinder and Mark Zandi, "How the Great Recession Was Brought to an End," Moody's Analytics, July 2010.

employment about 10 million jobs *higher than it otherwise would have been* in both 2011 and 2012. That translates, roughly, to an unemployment rate about 6½% *lower* than it otherwise would have been.

Spending from the TARP, of course, is long gone, although some funds are still outstanding. Spending and tax cuts from the Recovery Act peaked in the second and third quarters of 2009, and have been more or less declining ever since. In fiscal year 2011, they amounted to about 1% of GDP; in fiscal 2012, they will be perhaps half that amount. In other words, without the December 2010 extension of the payroll and income tax cuts, the *change* in fiscal stimulus would have turned notably *negative*--a drag on growth. Correspondingly, if you look at the major components of real GDP growth, the contribution of Federal government purchases of goods and services has been mostly *negative* since the third quarter of 2010. This fact does not accord at all with the popular notion that we are suffering from a bout of runaway federal spending. It is also one reason why the recovery has been so tepid. (Failure to address the foreclosure problem is another.)

A week ago, I published an op-ed piece in the *Wall Street Journal*, exploding what I called four myths about the budget deficit.<sup>4</sup> One of them is that we have an urgent deficit problem that must be tackled right away, lest we become the next Greece. On this view, any further fiscal stimulus must be “paid for” immediately, lest we spook the markets. But in fact, world financial markets are eager to lend the United States government vast amounts at *negative* real interest rates. That means that, in purchasing power terms, they are paying *us* to borrow *their* money! As an example of sensible budget policy in today’s environment, I suggested coupling

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<sup>4</sup> Alan S. Blinder, “Four Deficit Myths and a Frightening Fact,” *Wall Street Journal*, January 19, 2012.

another \$500 billion in stimulus spending with \$5 *trillion* in deficit reduction, enacted now but not starting until, say, 2014.

A second myth, which I realize comes straight from the conventional ten-year budget window, is the obsessive focus on the next ten years. In fact, if you look at CBOs long-term projections, what happens over the next five years is fairly benign, and what happens over the next ten barely matters (except as prologue to the future). Our deficit problem is a whopper, but it is much longer-term than that. The deficit and debt only start exploding in the 2020s, the 2030s, and beyond.

Why? The answer is remarkably simple: healthcare costs. As I noted in that *Journal* piece, 100% or more of the projected increase in the *primary* (that is, non-interest) deficit comes from rising healthcare expenditures.

Finally, to the luck issue: My outlook for calendar year 2012 is for roughly 2½% growth, the same tepid pace we have averaged since 2009, *minus* whatever we lose to bad macroeconomic luck. The biggest threat on the horizon is financial contagion from Europe. The latest news on that front is pretty good, if you don't look too hard at Greece. But that could change any day. If the European financial system blows up in post-Lehman fashion, most or all of that putative 2½% growth could go down the drain.

The other major risk--which, to me, is incalculable--comes from the Middle East and oil prices. Modest fluctuations in oil prices are macroeconomically negligible events. But if, say, a closing of the Strait of Hormuz sends oil prices skyrocketing, the damage to the US economy could be consequential.

So, in sum, the near-term outlook is for mediocrity if we are lucky and stagnation if we are not. I would have hoped the United States of America had higher aspirations than that. I would also have hoped that fiscal policy would help, not hinder, the recovery.

Thank you very much for listening. I would be happy to answer any questions.